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UNCLAS SECTION 01 OF 04 TEGUCIGALPA 000752

SIPDIS

SENSITIVE

STATE FOR WHA/CEN, WHA/EPSC, EB/TPP/BTA/ANA
STATE PASS AID FOR LAC/CEN
PASS TO USTR FOR ANDREA GASH DURKIN
PASS TO USTR FOR SARAH SIPKINS
COMMERCE FOR ITA/JEFFREY DUTTON
TREASURY FOR BONNIE RESNICK

E.O. 12958: N/A

TAGS: ETRD KTEX HO
SUBJECT: U.S.-CAFTA: Honduran Textile Goals in the U.S.-CAFTA Negotiations

REF: A) TEGUC 00546
B) TEGUC 01391
C) TEGUC 02647

¶1. (SBU) Summary: Honduras can be expected to fight hard in the U.S.-CAFTA textile negotiations for rules of origin that allow use of fabrics produced in NAFTA, Central American, CBI and Andean countries, including allowing the manufacture of woven products, short supply provisions and flexible rules of origin mechanisms such as accumulation. The GOH will continue to insist on maintaining special import regimes after tariffs in the U.S.-CAFTA region are eliminated because of their interest in short supply provisions and Honduras' belief that the free trade zones are a key reason for Honduras' success in the sector to date. In addition, many Honduran firms (even those which do not export) have come to consider the tax exemptions an entitlement. Unless the government's fiscal woes worsen significantly, we expect the GOH to insist on maintaining its "WTO right" to provide these tax incentives to investors. End Summary.

The Maquila Industry

¶2. (SBU) The attraction of the apparel assembly and related maquila operations has been one of Honduras' few success stories in diversifying from traditional agricultural exports such as bananas and coffee. The sector was expected to expand at double-digit rates after the adoption of expanded Caribbean Basin Trade Partnership Act (CBTPA) benefits in the U.S. but instead contracted for two years due to the downturn in the U.S. economy. The importance of the sector to job creation and export earnings and the need to remain competitive after the planned elimination of worldwide textile and apparel quotas in 2005 make expanded market access for Honduran textiles and apparel its most important goal in U.S.-CAFTA negotiations.

¶3. (U) Accumulated investment in the sector in 2002 totaled USD 1.422 billion, with USD 981.12 million in foreign investment. Accumulated U.S. investment in the sector is estimated at 568.8 million, or 40 percent of the total maquila investment. Currently, there are approximately 66 U.S. textile companies in Honduras with the most prominent being Fruit of Loom, Sara Lee, Russell, Hugger, Dickies and Jockey. Honduran companies account for some USD 440.8 million, or 31 percent of total industry investment. The rest of the investment is principally split between Korean, Canadian, Taiwanese and Chinese companies.

Origin of Accumulated Investment in 2002 (USD Millions)

U.S.	568.80
Honduras	440.80
Korea	213.30
China	56.88
Canada	49.20
Taiwan	28.44
Singapore	18.80
Other	45.78

Source: Honduran Maquila Association

¶4. (U) The downturn in the U.S. economy since 2001 has led to maquila closings, net job losses in the sector and lower than expected earnings for 2002. Total employment in the sector by December 2002 totaled 107,000 (approximately 26 percent of the country's private sector workforce). The industry had grown to over 125,000 in 2000 and officials predicted that maquila employment would double by 2005 to 250,000 jobs. However, that estimate has been substantially lowered to around 150,000 by 2005.

Industry Employment

1995	65,000
1996	76,000
1997	87,000
1998	110,000
1999	120,000
2000	125,000
2001	110,000
2002	107,000

Source: Honduran Maquila Association

¶5. (U) Maquila sector exports have more than doubled since 1995 when the industry registered USD 921 million in sales. In 2002, exports decreased to USD 2,287.6 billion compared to USD 2.344 billion in 2001. However, Honduras is still the third ranked exporter of textiles worldwide, following Mexico and China.

Exports (USD millions)

1995	921.1
1996	1,219.5
1997	1,659.0
1998	1,855.1
1999	2,158.3
2000	2,361.8
2001	2,344.2
2002	2,287.6

Source: Honduran Maquila Association

¶6. (U) The unilateral preferences provided by the USG to Honduran apparel industry through the Caribbean Basin Initiative (CBI) and related programs helped launch the growth in the industry in Honduras. According to the GOH, Honduras' exports to the U.S. of textiles and apparel grew from 27 percent of total exports to the U.S. in 1990 to 70 percent of total exports to the U.S. in 2001.

¶7. (U) GOH officials also emphasize in their discussions on the sector that the U.S. and Central American textile markets have become more and more interrelated. They cite the figure that U.S. cotton yarn exports to Honduras doubled in the period from 2001 to 2002, after passage of the Trade Development Act.

U.S-CAFTA Negotiating Goals

¶8. (SBU) In February 4, 2003 written testimony by the Embassy of Honduras before the U.S. International Trade Commission on investigation 332-338, the Honduran Embassy spelled out the GOH's negotiating goals on textiles bluntly:

-- Allow for the development of a seamless hemispheric textile and apparel industry;
-- Establish rules of origin that are flexible enough to allow the use of fabrics produced in NAFTA, Central America, CBI and Andean countries and which will allow the manufacture of woven products;
-- Rules of origin that include provisions such as TPL's, required percentages of regional and U.S. fabric, or inputs (accumulation), or similar mechanisms that will allow the integrated U.S.-Central American textile industry to use cost competitive fabrics;
-- Integrate and simplify the custom compliance and security programs for Central America so the region's industry can be competitive;
-- Establish technical provisions for qualifying textiles and apparel that will allow, among other procedures, dyeing, finishing and printing of all fabrics in the region; access for woven fabrics and commercially reasonable use of short supply provisions.

Drawback and Free Trade Zones

¶9. (SBU) Hondurans firmly believe that, in addition to the U.S.'s CBI and CBTPA programs, the country's success as the number three exporter of textiles to the U.S. is rooted in its three free trade zone regimes. During the negotiations leading up to the launch of the Doha Agenda, one of the GOH's main goals was to secure agreement on its "right," under Article 7 of the Subsidies Agreement, to continue to operate free trade zones and provide related investment incentives, for 10 years. Note: Honduras still has a per capita income under the Article 7 cap of USD 1000 but this level should be exceeded in the next couple of years; in addition, it should be noted that international financial institutions believe the Honduran GDP is generally understated. End Note. The Honduran Finance Ministry and to a lesser extent the rest of the GOH is aware that the web of tax waivers provided through these programs and many other

special laws is costing the government dearly in foregone tax receipts. These revenue losses in turn have contributed to budget deficits, failure to meet IMF targets and the postponement of its HIPC debt relief). Nonetheless, they continue to argue fiercely that the free trade zones are indispensable to Central America's continued competitiveness. It should also be recognized that in the current domestic political environment, a U.S.-CAFTA agreement which forced the removal of these tax exemptions from so many of the country's prominent Honduran investors (30-40 percent of the investment is Honduran) would not be considered viable, no matter how attractive other benefits might be.

¶10. (SBU) The three principal free trade zone regimes are:

-- Temporary Importation regime (Regimen de importacion temporal or RIT). Benefits are provided to Honduran-owned producers of any kind of product or service. The regime was set up in the 1980s in order to provide Honduran national non-traditional exporters with tax incentives given in previous years to foreign investors (however, over the years implementation has been lax and many producers for the local market have also been given these RIT exemptions). Customs benefits include: tax-free importation of all raw materials, intermediate goods, and capital goods exclusively related to production. These companies were also exempt from income tax until 1994. The beneficiaries are allowed to sell inputs, intermediate goods and final goods to other companies, free of sales tax. The beneficiaries can buy locally made goods used directly in production process and receive either an exemption from sales tax or an income tax credit. Approximately 530 Honduran establishments are incorporated under the RIT regime, of which close to 100 produce raw material, 150 produce food products and 120 produce textiles and apparel.

-- Free Processing Industrial Zones (Zonas Industriales de Libre Procesamiento or ZIP) and Free Zones (Zona Libre or ZOLI). The ZIP industrial parks house only manufacturing companies producing for export, which engage in transformation of imported imports into final exported products. There are currently eight operating ZIP companies which house 48 assembly plants. Enterprises established under the ZOLI regime receive similar benefits, but do not have to be located in a special zone or industrial park. Companies in ZIPs and ZOLIs are exempt from paying import duties on raw materials, intermediate products, and capital goods, and these do not need to be linked directly to the productive process. ZIP companies are exempt from the national income tax for 20 years, and from municipal taxes for 10 years. ZOLI firms have permanent exemptions from income tax and municipal taxes. The companies are also provided unrestricted currency conversion and customs clearance is performed on-site (by contracted customs officials whose salaries are paid by the company).

¶11. (SBU) A recent IDB sponsored study of Honduran tax policy found that in the year 2000, the special free trade zone regimes resulted in 47 million lempiras (USD 3.25 million) in waived export duties and 553 million (USD 37.9 million) in waived sales taxes. Of these amounts, the majority of tax exemptions (39 million lempiras in customs duties and 467 million lempiras in waived sales taxes) went to Honduran companies under the RIT system. There is no estimate of waived duties for companies operating in the ZIP and ZOLI regimes. The study identified a negligible amount (around USD 150) in drawback refunded to companies in 2000.

¶12. (SBU) The study also identified several flaws with the current system of investment incentives for exporting firms. Of particular note is the fact that foreign firms with assembly plants tend to treat their Honduran plants as a cost center. Their profits are therefore not attributable to their Honduran activities and they would generally be reflected in the company's consolidated income statements in their home country. For these foreign firms, the income tax exemptions are considered redundant and unnecessary to encourage foreign investment. In other cases, it is possible that the signing of a Double Taxation agreement with the U.S. and other investor countries could help spur additional foreign investment without forfeiting tax revenues. The GOH has recently asked the Embassy for more information on requesting that the Department of Treasury negotiate a Double Taxation treaty. Finally, many other Honduran laws have been enacted over the years giving a variety of sectors and individual companies special import duty and other tax exemptions.

¶13. (SBU) Another reason for the Honduran insistence on the maintenance of special import regimes, even after negotiating U.S.-CAFTA, lies in their negotiating goal of obtaining U.S. market access for woven fabrics and goods and use of short supply provisions (that allow duty free treatment of Central American products made from non-U.S. or regional fabric if that product is not available from

regional sources). Honduran trade officials note that the NAFTA has such provisions. If U.S.-CAFTA includes short supply provisions, Honduran companies would want to continue to import the fabric through special import regimes.

¶14. (SBU) GOH trade officials reject the argument that continued use of duty waivers for non-U.S. or regional fabric will provide a platform for circumvention of the rules of origin requirements. Honduras has done fairly well over the years in U.S. Customs Service inspections of compliance with CBI and CBTPA rules.

Customs Compliance and Security

¶15. (SBU) The U.S. Customs Service's new rules on 24 hour advance manifests and expectations of additional port security requirements are of great concern to the Honduran textile and apparel industry, which specializes in quick deliveries because of its proximity to the U.S. market. Puerto Cortes and the Honduran textile and apparel sector would benefit tremendously from cooperation on port security, and if possible, initiation of a Container Security Initiative program in Puerto Cortes.
Palmer